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## Contribution of a Built-In Loss to a Partnership

By Douglas A. Kahn



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In 2004 Congress amended the code to prevent the use of a partnership contribution as a means of transferring a deduction for a built-in loss from one person to another. That amendment has undermined the application of the remedial method (and the traditional method with curative allocations) that the regulations provide for the allocation of a contributed built-in gain or loss, Kahn argues. He also asserts that the 2004 amendment distorts income reporting.

### A. Transfer of a Loss Deduction

Before 2004, it was possible to use the partnership tax provisions of the code to shift the benefit of a loss deduction for a decline in property value from the person who incurred it to another person. One method of accomplishing that goal involved the contribution of depreciated property to a partnership.<sup>1</sup>

<sup>1</sup>If a partnership does not have a section 754 election in effect, a shifting and duplication of the tax benefits from a partnership's built-in loss in partnership property could take place when a partner transferred his partnership interest to another at a time the partnership held depreciated property or when a partnership distributed depreciated property to a partner. In section 833(b) and (c) of the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), Congress addressed that situation by amending sections 734 and 743 to require a reduction of the partnership's inside basis in its assets basically when the amount of benefit derived from a built-in loss exceeds \$250,000. Sections 734(b), 734(d), 743(b), and 743(d). At least one commentator suggested that regardless of the amount of the built-in loss, section 704(c)(1)(A) might be extended to apply in that circumstance. Lukasz Rachuba, "New Issues With Partnership Built-In Loss Property," *Tax Notes*, June 20, 2005, p. 1569, *Doc 2005-11537*, 2005 TNT 118-42. This article will focus on the circumstances in which depreciated property is contributed to a partnership; I

(Footnote continued in next column.)

**1. Summary of partnership tax rules.** The general tax rule is that when property is contributed to a partnership in exchange for a partnership interest, no gain or loss is recognized by either the contributing party or the partnership.<sup>2</sup> The partnership takes the same basis in the contributed property that the contributing partner had in that property.<sup>3</sup> In general, the contributing partner will have the same basis in the partnership interest acquired in the exchange as the partner had in the contributed property.<sup>4</sup>

When a partnership distributes property (including cash) to a partner, generally neither the partnership nor the partner will recognize a gain or loss, although there are exceptions to that general rule.<sup>5</sup> The general rule applies to a current or liquidating distribution<sup>6</sup> to the partner as contrasted with a sale or exchange between the partner and the partnership.

For current distributions, the partner takes a basis in the distributed property equal to the basis that the partnership had therein, subject to the limitation that the partner's basis cannot exceed the partner's outside basis in his partnership interest

will not discuss the related situation of manipulating the tax benefits to be derived from a decline in the value of property in the partnership's hands.

<sup>2</sup>Section 721(a). A limited exception to that rule is that gain is recognized on the transfer of appreciated property to a partnership that would qualify as an investment company if it were incorporated. Section 721(b).

<sup>3</sup>Section 723. If the asset contributed to the partnership had been personally used by the contributing partner (as contrasted with business use or investment property), and if it is a depreciated asset, the partnership can have two bases for that asset: one basis equal to the asset's fair market value at the time of contribution for purposes of measuring a loss or depreciation and a different basis equal to the contributing partner's basis for purposes of measuring a gain. See *Au v. Commissioner*, 40 T.C. 264 (1963), *aff'd per curiam*, 330 F.2d 1008 (9th Cir. 1964).

<sup>4</sup>Section 722.

<sup>5</sup>Section 731. A partner will recognize a gain if the cash distributed to the partner exceeds his basis in his partnership interest. Section 731(a)(1). A partner can recognize a loss on receiving a liquidating distribution (as distinguished from a current distribution) in some circumstances. Section 731(a)(2). In some circumstances, a gain or loss can be recognized by both the distributee partner and the partnership when section 751(b) applies.

<sup>6</sup>A current distribution is a distribution from the partnership that does not liquidate the partner's interest in the partnership. A liquidating distribution is a distribution from the partnership that does liquidate the partner's interest in the partnership.

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reduced by any cash distributed to him.<sup>7</sup> The partner's outside basis in his partnership interest is reduced (but not below zero) by the amount of money distributed to him plus the amount of basis he takes in the in-kind property that was distributed to him.<sup>8</sup>

For a liquidating distribution, the partner allocates his outside basis in his partnership interest, reduced by any cash received, to the in-kind property distributed to him.<sup>9</sup> In effect, he simply transfers his basis in his partnership interest, reduced by cash received, to the in-kind property that was distributed to him as part of the liquidating distribution.

Partnerships are given great latitude in determining how the tax items of the partnership (such as gains, losses, depreciation, and deductions) are to be allocated among the partners. With one exception, an allocation by the partnership will be respected for tax purposes if it has substantial economic effect.<sup>10</sup> The one exception arises when a partner contributes an appreciated or depreciated asset to the partnership. As described below, the code requires that the tax items that the partnership incurs because of that appreciation or depreciation be allocated to the contributing partner.<sup>11</sup>

When property with a different basis from its value is contributed to a partnership, section 704(c)(1)(A) requires that any subsequent income, gain, loss, or deduction regarding that contributed property<sup>12</sup> be allocated among the partners in a manner that accounts for the difference between basis and value.<sup>13</sup> The purpose of that provision is to provide that the benefit or detriment of any built-in loss or gain be allocated to the contributing

partner. If the contributing partner transfers his partnership interest to another before all of the built-in gain or loss was allocated to him, the transferee steps into the shoes of the contributing partner so that any subsequent tax items that would have been allocated to the contributing partner will be allocated to the transferee.<sup>14</sup>

**2. Abusive use of partnership tax rules.** Despite the section 704(c)(1)(A) requirement for the allocation of built-in losses and gains, it was still possible before 2004 to use the partnership vehicle to transfer a deduction for a built-in loss to another and even to double the amount of the deduction. The following examples illustrate how that could have been done.

**Example 1:** George owned Land No. 1 with a basis of \$500,000 and a fair market value of \$300,000. George transferred the land to the newly formed GRA general partnership for a one-third interest in the partnership. GRA takes Land No. 1 with a \$500,000 basis, and George has a \$500,000 outside basis in his partnership interest.<sup>15</sup> Thus, GRA has a built-in loss of \$200,000 in Land No. 1, and George has a built-in loss of \$200,000 in his partnership interest. Roberta and Arthur each transferred \$300,000 cash to GRA in exchange for a one-third interest. GRA then purchased Land No. 2 for \$300,000 cash. More than one year later,<sup>16</sup> GRA distributed Land No. 2 to George in liquidation of his one-third interest in the partnership. GRA has never made a section 754 election. Roberta and Arthur then become equal partners in GRA. To simplify the computations, assume that GRA's income equaled its deductions in the intervening period so that all the partners had the same outside basis in their partnership interest that they had at the inception of the partnership.

George's basis in the distributed Land No. 2 is \$500,000, even though the basis that GRA had in Land No. 2 was only \$300,000. George transfers his outside basis in his partnership interest (\$500,000) to Land No. 2.<sup>17</sup> Since no section 754 election is in effect, GRA will continue to have a \$500,000 basis in Land No. 1.<sup>18</sup>

George later sells Land No. 2 for its value of \$300,000, and he recognizes a loss of \$200,000 on

<sup>7</sup>Section 732(a).

<sup>8</sup>Section 733.

<sup>9</sup>Section 732(b).

<sup>10</sup>Section 704(b). The regulations under section 704 provide an elaborate set of rules for determining whether a partnership's allocation of a tax item has substantial economic effect. *See* reg. section 1.704-1.

<sup>11</sup>Section 704(c)(1)(A).

<sup>12</sup>If the partnership disposes of that contributed property in a nonrecognition exchange, the section 704(c) allocation rules will apply to the substituted basis property that was acquired in the exchange. Reg. section 1.704-3(a)(8). Property subject to the allocation rules of section 704(c)(1)(A) is sometimes referred to as "section 704(c) property." Reg. section 1.704-3(a)(3)(i) and -3(a)(8).

<sup>13</sup>The regulations provide an exception when the disparity between basis and fair market value is small. If the difference between the aggregate value of all properties contributed by one person to the partnership in a tax year and the aggregate basis of those properties does not exceed 15 percent of the properties' adjusted basis, and if the total difference in those aggregate figures does not exceed \$20,000, the partnership has several elections available, one of which is to disregard section 704(c) completely. Reg. section 1.704-3(e).

<sup>14</sup>Section 704(c)(3); reg. section 1.704-3(a)(7).

<sup>15</sup>Sections 722 and 723.

<sup>16</sup>Given the more than one-year period, we will assume that the transaction will not be treated as a disguised exchange of Land No. 1 for Land No. 2 under section 707(a)(2)(B).

<sup>17</sup>Section 732(b).

<sup>18</sup>Even under current law, the 2004 amendment to section 734 would not apply because the additional basis that George obtained for the distributed property did not exceed \$250,000. Section 734(b) and (d)(1).

that sale. GRA then sells Land No. 1 for its then value of \$300,000, and it recognizes a loss of \$200,000 on that sale. The partnership's loss is allocated equally to Roberta and Arthur, each of whom will take a deduction of \$100,000. The consequence is that George has retained the tax benefit of his \$200,000 built-in loss in Land No. 1 and has also permitted Roberta and Arthur to deduct the same \$200,000 built-in loss. It is true that Roberta and Arthur do not get off scot-free. The \$100,000 loss allocated to each of them will reduce that person's outside basis in his partnership interest.<sup>19</sup> That reduction in basis *may* cause them to recognize a gain (or a smaller loss) on their subsequent disposition or liquidation of their partnership interest.<sup>20</sup> However, the principle of time value of money still makes it valuable for Roberta and Arthur to obtain the use of a deduction long before they might have to recognize income.

**Example 2:** The same facts as those stated in Example 1, except that GRA did not make a liquidating distribution of Land No. 2 to George. Instead, George sold his partnership interest to Mary for its value of \$300,000. George recognized a loss of \$200,000 on that sale. Since the partnership does not have a section 754 election in effect, GRA's inside basis in its assets is not changed as a result of that sale.<sup>21</sup> GRA later sells Land No. 1 for its value of \$300,000 and recognizes a loss of \$200,000 on that sale. Under the pre-2004 version of section 704(c)(1)(A), the \$200,000 loss will be allocated to Mary, who will reduce her outside basis in her partnership interest by that amount. The net result is that George will obtain the benefit of his \$200,000 built-in loss in Land No. 1 and will have transferred to Mary another \$200,000 deduction for the built-in loss in Land No. 1.

## B. The 2004 Amendment

Treasury deemed the situations described in the preceding two examples to be abusive. The 2004 amendments to sections 734 and 743 prevent that abuse from taking place if the amount involved exceeds \$250,000.<sup>22</sup> Since the amount involved in each of those two examples was less than \$250,000, the 2004 amendments to sections 734 and 743 do not apply. To deal with that situation, another 2004 amendment to the code added section 704(c)(1)(C). The purpose of adding subparagraph (C) was to

prevent anyone other than the contributing partner from obtaining any tax benefit from the excess of basis over the value of property contributed to a partnership. The added subparagraph (C) reads as follows:

(C) if any property so contributed has a built-in loss —

- i. such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and
- ii. except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C))(ii) over its fair market value at the time of contribution.

One issue concerns whether the added subparagraph (C) will prevent a transferee of the contributing partner's partnership interest from enjoying the benefit of the excess basis that the property has in the hands of the partnership. In Example 2 above, does section 704(c)(1)(C) prevent Mary from having a loss allocated to her when the partnership sold Land No. 1? The second sentence of section 704(c)(3) states, "Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner." Subparagraph (C)(i) provides that the built-in loss can be taken into account only for items allocated to the contributing partner. Since section 704(c)(3) says that a successor to a contributing partner is treated as a contributing partner, subparagraph (C)(i) does not prevent a transferee of the contributing partner from benefiting from that excess basis. However, subparagraph (C)(ii) prevents "other partners" from benefiting from the excess basis. In light of the provision in section 704(c)(3) treating a successor to the contributing partner as the contributing partner, one might conclude that the transferee of a contributing partner's partnership interest could benefit from the excess basis. But that would contravene the explicit purpose of Congress in adopting the 2004 amendment. The House report to the 2004 act's provision adopting subparagraph (C) states: "Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and

<sup>19</sup>Section 705(a)(2).

<sup>20</sup>If a partner holds his partnership interest until death, the basis in that interest will be changed to its FMV by section 1014.

<sup>21</sup>Even under current law, the 2004 amendment to section 743 would not apply because the amount of the partnership's built-in loss does not exceed \$250,000. Section 743(b) and (d)(1).

<sup>22</sup>Section 833 of the AJCA.



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the built-in loss is eliminated.”<sup>23</sup> Clearly, Congress intended to prevent the transferee partner from using any of the excess basis. It seems virtually certain that the courts will follow the obvious intent of Congress in construing the provision. The commentators unanimously assume that the transferee partner cannot benefit from the excess basis.

It is noteworthy that since subparagraph (C) applies to prevent a transferee of the contributing partner's interest from benefiting from the built-in loss, that rule will also apply when the partnership interest of the contributing partner is transferred by gift, legacy, or inheritance.<sup>24</sup> Section 704(c)(1)(C) provides that Treasury is authorized to create exceptions to that provision by promulgating regulations. It remains to be seen whether Treasury will exempt either donative or testamentary transfers from that provision. It seems unlikely that Treasury will exempt either of those situations. Even if the regulations do create an exception for a transfer by death, the 2004 amendment to section 743(b) will prevent the transferee from obtaining any benefit from the built-in loss if the amount of the partnership's built-in loss at death is greater than \$250,000. Since section 743(b) does not apply to donative transfers of a partnership interest, section 704(c)(1)(C) will be the only means of preventing the transfer of a built-in loss to a donee even when the amount of the built-in loss exceeds \$250,000.

A second problem is more complex and more difficult to resolve. To understand that issue, it is necessary first to explain the operation of the section 704(c)(1)(A) requirement that contributed built-in gain or loss be taken into account in making partnership allocations to partners. In discussing the operation of that provision, I will address only the situation in which the contributed item is later sold for a gain or loss. I will not discuss the allocation of depreciation deductions when a depreciable item is contributed to the partnership. The principles described below apply equally to depreciation deductions, but the application of those principles to depreciation can be more complex in some situations. Therefore, I have omitted discussion of depreciation to simplify the calculations.

**1. Methods of allocation.** There are different allocation methods available for applying the section 704(c)(1)(A) requirement that built-in gain or loss of

contributed property be taken into account. The regulations provide three different methods for the partnership to choose among<sup>25</sup>: the traditional method,<sup>26</sup> the traditional method with curative allocation,<sup>27</sup> and the remedial allocation method.<sup>28</sup> I will explain both the traditional method and the remedial allocation method. I will not discuss the traditional method with curative allocation.

**a. The traditional method and the ceiling rule.**

Under the traditional method, the tax items from contributed property (such as gain or loss from the disposition of that property or depreciation deductions for its use) are first allocated to the noncontributing partners in an amount equal to the book amount of those items that are allocated to them. Any remainder of the tax item is allocated to the contributing partner. The following example illustrates how that method operates in a basic situation.

**Example 3:** Rhonda contributes Land No. 1 to the BRT partnership in exchange for a one-third interest in the partnership. The other two partners, each of whom has a one-third interest, are Bert and Tilly. Rhonda's basis in Land No. 1 was \$200,000, and its FMV was \$250,000. The partnership has a \$200,000 basis in Land No. 1, and its book value to the partnership is equal to the property's FMV at the time of contribution — that is, \$250,000. Two years later BRT sells Land No. 1 for \$310,000. The partnership has elected to use the traditional method. The partnership has tax income of \$110,000 on that sale, and it has book income of \$60,000 (the difference between the amount realized on the sale and the land's book value of \$250,000). The \$60,000 book gain on the sale is allocated equally among the three equal partners so that each shows a book gain of \$20,000 and increases her capital account by that amount. Of the \$110,000 tax gain on the sale, \$20,000 is allocated to Bert, and a like amount is allocated to Tilly. In other words, the two noncontributing partners have tax gain allocated to them equal to the book gain that was allocated to them. That leaves \$70,000 of tax gain that has not yet been allocated to a partner. All of that \$70,000 tax gain is allocated to Rhonda, the contributing partner. In summary, of the \$110,000 tax gain on the sale, \$20,000 is allocated to Bert, \$20,000 to Tilly, and \$70,000 to Rhonda. Thus, in effect, Rhonda is taxed on the built-in gain

<sup>23</sup>H. Rep. No. 108-548, at 283 (2004), *Doc 2004-12632*, 2004 TNT 119-71.

<sup>24</sup>One treatise has noted that for a nonrecognition transfer of a partnership interest by a contributing partner (such as a section 351 exchange with a corporation for its stock), subparagraph (C) can result in a tax advantage to the taxpayers in some circumstances. William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 11.04[1][b] (4th ed.).

<sup>25</sup>The partnership can choose a different method from the three authorized by the regulations if it is reasonable. Reg. section 1.704-3(a). Even the three methods expressly authorized by the regulations are subject to an antiabuse rule, and the application of the method or combination of methods that the partnership employs must be reasonable. *Id.*

<sup>26</sup>Reg. section 1.704-3(b).

<sup>27</sup>Reg. section 1.704-3(c).

<sup>28</sup>Reg. section 1.704-3(d).

of \$50,000 that she contributed to the partnership plus \$20,000 representing her one-third share of the appreciation that took place after the contribution.

The plot thickens when the facts of Example 3 are changed so that there is a book loss on the sale of Land No. 1 even though there is a tax gain. In that case, each of the noncontributing partners would have a book loss equal to one-third of the partnership's book loss, but there would be no tax loss on the sale, and so there is no tax loss to allocate to them under the traditional method. That situation invokes the so-called ceiling rule.<sup>29</sup> The operation of the ceiling rule is illustrated in Example 4 below.

**Example 4:** The same facts as those stated in Example 3, except that BRT sold Land No. 1 for its then value of \$220,000 because the land had declined in value after it was contributed to the partnership. In that case, BRT would have a tax gain of \$20,000 on the sale of the land, since its basis in the land was \$200,000. The book value of Land No. 1 was its FMV at the time of contribution, which was \$250,000. Consequently, BRT had a book loss of \$30,000 on the sale, of which \$10,000 was allocated to each partner, whose capital account is therefore reduced by that amount. The two noncontributing partners (Bert and Tilly) should receive a tax loss of \$10,000 to equal the book loss that was allocated to them, but there was no tax loss on the sale. The ceiling rule operates by providing that the tax gain or loss that can be allocated to noncontributing partners cannot exceed the amount of tax gain or loss incurred by the partnership. Consequently, no tax loss is allocated to Bert and Tilly. The entire tax gain of \$20,000 that BRT recognized on the sale is allocated to Rhonda, the contributing partner. The effect of the ceiling rule is that the contributing partner (Rhonda) gets the entire tax benefit of the \$30,000 decline in value that occurred while the partnership held the land, even though each of the partners economically suffered one-third of that loss in value.

**b. The remedial method.** The other two methods authorized by the regulations are designed to deal with the ceiling rule. Those two methods operate the same as the traditional method except when the ceiling rule would apply. Of those two other methods, I will describe only the remedial allocation method.

Under the remedial method, the amount of tax gain or loss that is allocated to a noncontributing partner is equal to the book gain or loss that is allocated to that partner. This tax allocation is made regardless of whether the partnership had that much tax gain or loss on its sale of the contributed

property. In other words, the ceiling rule does not apply to the remedial method. To make up for any notional tax gain or loss allocated to a noncontributing partner, an equal amount of the opposite character is allocated to the contributing partner. For example, if the partnership sold a contributed asset for a tax gain but a book loss, each noncontributing partner would have a tax loss allocated to him equal to his share of the book loss. An equal amount of tax gain would be allocated to the contributing partner in addition to the allocation to him of the entire amount of tax gain that the partnership recognized on the sale. The operation of the remedial method is illustrated in Example 5 below.

**Example 5:** The same facts as those stated in Example 4, except that the partnership has elected to use the remedial allocation method. On the sale of the land for \$220,000, BRT had a book loss of \$30,000, of which \$10,000 is allocated to each partner. Under the remedial method, Bert and Tilly (the noncontributing partners) are each allocated a \$10,000 tax loss having the same character as that item would have had if there had been a tax loss. So, if a loss on the sale of Land No. 1 would have produced a long-term capital loss, the \$10,000 loss allocated to Bert and Tilly will be characterized as a long-term capital loss. To balance the tax loss allocated to Bert and Tilly, a \$20,000 gain will be allocated to Rhonda. That \$20,000 of tax gain allocated to Rhonda will have the same character as the loss that was allocated to the noncontributing partners; so, on the assumed facts of this example, it will be a long-term capital gain. Those allocations of gains and losses are notional tax items and do not depend on the partnership having any actual tax gain or loss. Also, the \$20,000 tax gain (a long-term capital gain) that BRT actually recognized on the sale will be allocated to Rhonda. In sum, Rhonda will recognize \$40,000 of long-term capital gain — \$20,000 as her share of the gain that BRT recognized on the sale and another \$20,000 as a notional amount to balance the \$20,000 of notional loss allocated to the two noncontributing partners.

**2. Operation of the 2004 amendment.** Let us now turn to the operation of the 2004 amendment that added section 704(c)(1)(C). The first example below will apply subparagraph (C) to a partnership that has adopted the traditional method, and the next example will consider the application of that subparagraph to a partnership that has adopted the remedial method. The interpretive issue arises in the second situation. The circumstances of both examples below occurred after 2004.

**Example 6:** Paula transferred Land No. 1 to the ABP partnership in exchange for a one-third partnership interest. Land No. 1 had an FMV of

<sup>29</sup>Reg. section 1.704-3(b).

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\$200,000, and Paula had a basis of \$400,000 in it. Under section 723, the partnership takes a basis of \$400,000 in Land No. 1. The partnership has elected to use the traditional method. Albert and Barbara each hold a one-third interest in the ABP partnership. Several years later, ABP sells Land No. 1 for \$260,000. Since the book value of the land was \$200,000, the partnership has a book gain of \$60,000, of which \$20,000 is allocated to each partner. Under the traditional method, ignoring section 704(c)(1)(C) for the moment, no tax gain would be allocated to Albert or Barbara (the noncontributing partners) because there was no tax gain on the sale. The \$140,000 tax loss that the partnership recognized on the sale would all be allocated to Paula (the contributing partner). But section 704(c)(1)(C) requires a different result. Under that provision, in determining the amount of tax items to be allocated to Albert and Barbara, the partnership's basis in Land No. 1 is deemed to be equal to its value at the time of contribution (that is, \$200,000). So, for purposes of making the allocation to Albert and Barbara, ABP is deemed to have had a \$200,000 basis in the land and so recognized a gain of \$60,000, of which one-third (\$20,000) is allocated to Arthur and one-third (\$20,000) is allocated to Barbara. That is the same result that would have occurred if the remedial method had been in effect, except that section 704(c)(1)(C) does not provide for an offsetting loss deduction for Paula. Instead, Paula will be allocated only the \$140,000 tax loss that the partnership incurred on the sale (\$400,000 basis less the \$260,000 amount realized). In sum, Paula will be allocated a \$140,000 tax loss, and Arthur and Barbara will each be allocated a \$20,000 tax gain. If Land No. 1 is a capital asset, the gains and losses allocated to the partners will be long-term capital gains and losses.

**Example 7:** The same facts as those stated in Example 6, except that the ABP partnership has elected to use the remedial allocation method. As noted above, section 704(c)(1)(C) requires that \$20,000 of tax gain be allocated each to Arthur and Barbara because they are not permitted to have any benefit from the excess of the contributed property's basis (\$400,000) over its value at the time of contribution (\$200,000). Subparagraph (C) does not create a notional amount of \$40,000 of tax loss to be allocated to the contributing partner (Paula) to offset the gain allocated to the two noncontributing partners. Since the tax gain allocated to the noncontributing partners is not made as an allocation of a notional tax item under the regulations of section 704(c)(1)(A), neither the ceiling rule nor the remedial allocation method comes into play. Consequently, the result is the same as the result reached in Example 6; namely, Paula will recognize a

\$140,000 tax loss, and Arthur and Barbara will each recognize a \$20,000 tax gain.

The application of section 704(c)(1)(C) in Example 7 arrives at a result that is inconsistent with the goals and underlying principles of the remedial method. The remedial method overturns the ceiling rule and prevents the distortion engendered by that rule by creating offsetting tax allocations to the contributing and noncontributing partners so that items of gain or loss are allocated between them that are independent of the actual tax gain or loss the partnership recognized. As a result of the basis adjustment required by the 2004 amendment, gain is created for the noncontributing partners when no actual tax gain existed, and no loss is created to balance that figure. In Example 7, \$400,000 had been invested in Land No. 1, and \$260,000 was obtained in payment for it. So the overall transaction resulted in a net loss of \$140,000. The aggregate amount of allocations that are made therefore should total \$140,000 of loss. Instead, while \$140,000 loss is allocated to Paula, \$40,000 gain is allocated to the other two partners. The aggregate is a loss of only \$100,000 instead of the \$140,000 total that it should be.<sup>30</sup> The remedial method is designed to prevent that distortion from taking place, but only when that allocation method is elected by the partnership.

That application of subparagraph (C) effectively eliminates the use of the remedial method (and also of the traditional method with curative allocation) in most situations in which the contributed depreciated asset increases in value in the hands of the partnership. It is doubtful that Congress contemplated that consequence or that lawmakers would have adopted the provision in that form if it had been contemplated. Nevertheless, that will be the result unless Treasury promulgates regulations providing that when the remedial method is elected and the contributing partner still has a partnership interest, the remedial method will be applied in lieu of section 704(c)(1)(C).<sup>31</sup> Section 704(c)(1)(C)(ii) expressly authorizes Treasury to promulgate regulations that exclude some circumstances from the

<sup>30</sup>The distortion noted above in the text can be described another way. Paula realized a loss of \$200,000 when she exchanged Land No. 1 for a partnership interest. But none of that loss was recognized because of section 721. In the hands of the partnership, Land No. 1 appreciated by the amount of \$60,000, of which one-third or \$20,000 was allocable to the interest held by Paula. So, on the partnership's sale of Land No. 1, Paula suffered a loss of \$180,000 — *i.e.*, the \$200,000 loss she had previously realized minus her \$20,000 share of the subsequent appreciation of the land. But the application of section 704(c)(1)(C) provides Paula with a loss deduction of only \$140,000 — \$40,000 less than the amount she should have.

<sup>31</sup>See Rachuba, *supra* note 1.



application of that provision. It remains to be seen whether Treasury will address this issue in its regulations.

While I have focused on the remedial allocation method in this article, much of what has been said about the conflict of subparagraph (C) with the remedial method is equally applicable to the traditional method with curative allocation.

It is noteworthy that the application of subparagraph (C) creates a distortion even when there has been no remedial method election. Example 6 illustrates that distortion. Some commentators have proposed that to prevent that distortion, Treasury should promulgate regulations that effectively would provide the contributing partner with an offsetting notional tax item regardless of whether the remedial method was adopted by the partnership.<sup>32</sup> While curing a distortion has much to be said for it, there are reasons Treasury is unlikely to take that position. Before the 2004 amendments, the ceiling rule created distortions as indicated above. Treasury chose to cure them only if the remedial method or the traditional method with curative application is adopted, and the latter method does not cure the distortion in all circumstances. The 2004 amendment adopting subparagraph (C) has no effect on the contribution of appreciated property, and the distortion that the ceiling rule can cause in that circumstance was left unabated unless the remedial or curative method is adopted. In other words, the problem of a distortion was left undisturbed in that situation. Moreover, even before subparagraph (C) was added to the code, the operation of the ceiling rule could cause distortions when depreciated property was contributed to a partnership. The addition of subparagraph (C) did not create a distortion; it merely changed the nature of a distortion that already existed. To the extent that subparagraph (C) prevents the election of the remedial method from eliminating a distortion, it runs counter to the regulatory purpose of that latter provision. However, when subparagraph (C) merely perpetuates a distortion that previously existed, there is much less impetus to change the

rules to eliminate it. In effect, the proposal of Laura and Noel Cunningham<sup>33</sup> would impose the remedial method for contributed depreciated property, but not for contributed appreciated property.

The 2004 adoption of subparagraph (C) has created many more distortions than the ones noted in this article. Several commentators have listed and described them.<sup>34</sup>

Although the evil at which the 2004 amendments were aimed is the transfer of a loss deduction to another party, the method employed of reducing the basis of the contributed property can cause the transferee to recognize a gain. As shown in examples 6 and 7, the provision is not limited to preventing the transferee from deducting a built-in loss, but it can cause the recognition of gain. There are other tax provisions that operate in some circumstances (for example, gifts) to prevent a transferee from obtaining a deduction for a built-in loss but allow the transferee to use the excess basis to prevent the recognition of gain because of subsequent appreciation.<sup>35</sup> However, there are also other tax provisions that prevent the use of excess basis in determining a transferee's subsequent gain as well as his loss.<sup>36</sup> So, this aspect of the 2004 amendment is not out of sync with the structure of the code.

### C. Conclusion

Treasury needs to clarify several aspects of section 704(c). If section 704(c)(1)(C) applies when a partnership has elected to use the remedial allocation method, the provision will effectively eviscerate the remedial method in some circumstances. The same is true for the traditional method with curative allocation. If Treasury agrees that it is undesirable to prevent the operation of the remedial method or the traditional method with curative allocation when the contributing partner still has a partnership interest, it should promulgate regulations exempting those situations from the application of the provision.

<sup>33</sup>*Id.*

<sup>34</sup>See Alan Gunn and James R. Repetti, *Partnership Income Taxation* (4th ed. 2005); Darryll K. Jones, "It's the Ceiling Rule, Stupid," *Tax Notes*, June 20, 2005, p. 1579, Doc 2005-12754, or 2005 TNT 118-41. Jones questioned whether all of those distortions can be cured by regulations. *Id.* at 1582.

<sup>35</sup>For example, sections 267(d) and 1015(a). Cf. reg. section 1.165-9(b).

<sup>36</sup>See, e.g., section 362(e).

<sup>32</sup>Laura Cunningham and Noel Cunningham, *The Logic of Subchapter K*, 96-97 (4th ed. 2011). The authors of that work express the determination of the notional amount of loss to be allocated to the contributing property differently from the description above, but the result would be the same, and it actually amounts to the same thing.